DOW THEORY LETTERS INC.

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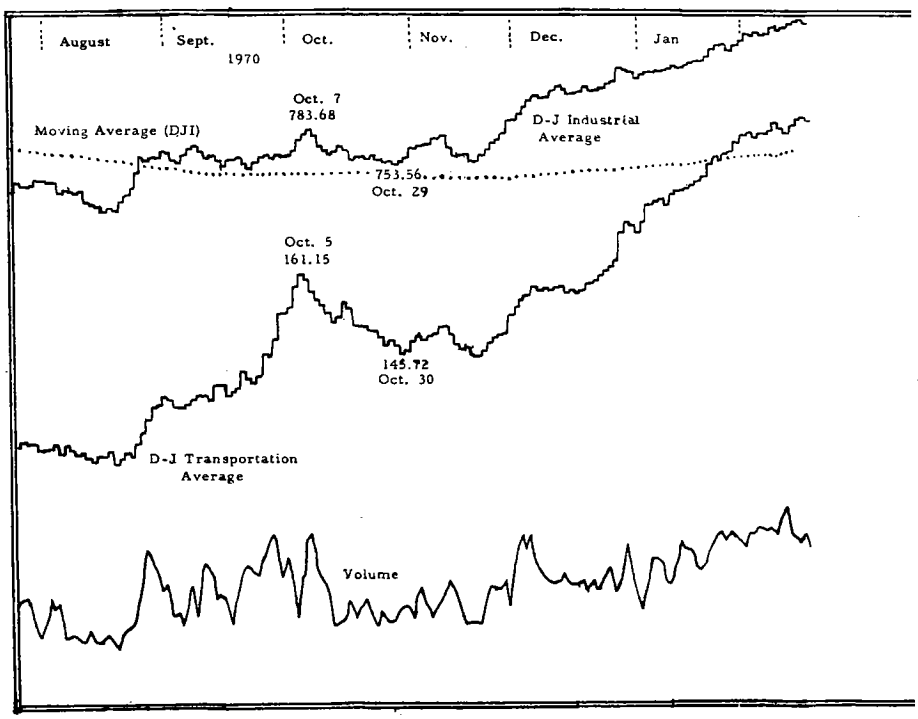
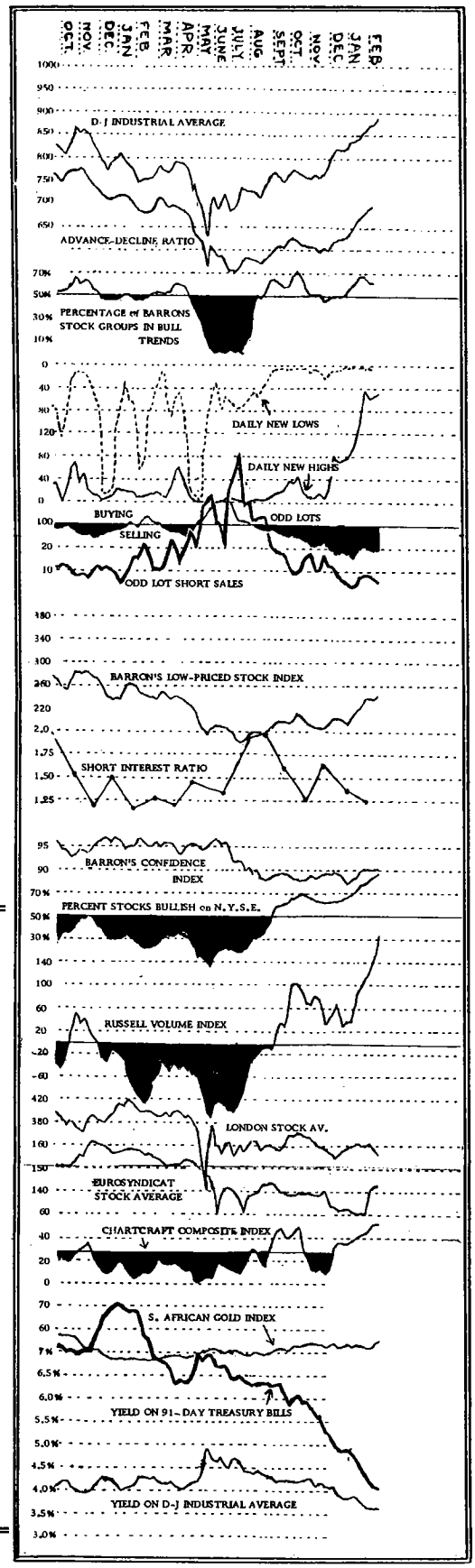
THE PICTURE: Aside from the stock market itself, one of the big battles which could be looming in 1971 is between Mr. Nixon and Federal Reserve Board Chairman Arthur Burns. Mr. Nixon is now embarking on that strange new game plan known as the "full employment budget", which means that the Government is going ahead just as if unemployment was now 4% and the country was in dandy shape. This type of fantasy-budgeting, says Mr. Nixon, "is in the nature of a self-fulfilling prophecy" since the stimulation of the full-employment budget (translation: spending just as if the money was going to come in) will jazz the economy up so thoroughly that business will get better, profits will go up, unemployment will drop, and the wish will father the fact.

But Mr. Burns may not swallow the latest Administration game-fantasy. For Mr. Burns is also worried about giant deficits and inflation and losses of gold, and Mr. Burns has been around a long time. In answer to the repeated Administration requests that the Fed pump up the money supply at perhaps an 8 or 9% rate, Burns stated, "The chief retarding factor in the economy is not the money supply — there's ample money around, ample liquidity... Confidence is far more important, and what we need in our country more than anything else is a regaining of confidence — regaining of confidence in Government, regaining of confidence in economic policy."

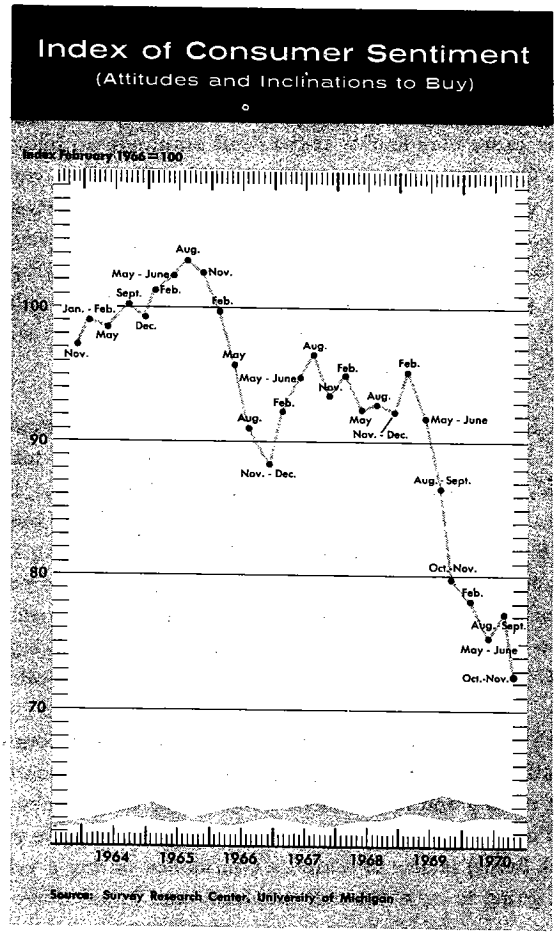
Note that Mr. Burns used the word "confidence" four times in a row. Being a rather astute economist, Burns knows that you can drown the nation in fiat money and if there's no confidence, that money will just be hoarded and used to pay off debt; it won't be spent. So the problem (and I agree with Burns) is how to rekindle confidence during a primary bear market. It's going to be a difficult problem, and I don't have any ready answers.





A few Letters back I published a piece on Arthur Okun's "Discomfort Index" which is a gauge which Mr. Okun uses to measure the happiness or discomfort of the consumer. The Index is very simply constructed; it is the total of the unemployment rate and the consumer price rise rate. For the edification of readers, I will show those tabulations again at right. For most of 1970, I would guess that the Index was around 11%. The latest consumer price rise rate for early 1971 is 6% and the unemployment rate is 6%. That means that the "Discomfort Index" is currently at 12%, highest in a generation.

Year	*Index*	*Year*	*Index*
1951	11.3%	1961	7.8%
1953	3.7%	1963	6.9%
1955	4.1%	1965	6.2%
1957	7.8%	1967	6.6%
1959	6.3%	1969	8.9%



The 12% rate jibes with the latest Univ. of Michigan Index of Consumer Sentiment (see chart) which shows consumer sentiment at its lowest ebb since the poll began. This, then constitutes one of the major problems which Mr. Nixon is facing during this bear market, and I suggest that hypocrisy, half-truths, wishful thinking and "full-employment budgets" aren't going to boost consumer confidence very much.

I've been vitally interested in psychology for the past twenty years, and in my experience two factors must be present to produce confidence. First, confidence can only be produced when you deal with the truth. Second, the truth itself (or the facts) must have either elements of real hope in them, or they must be favorable. I don't care whether you're dealing with your own life, a business or the national economy, those two factors must exist if confidence is to be present.

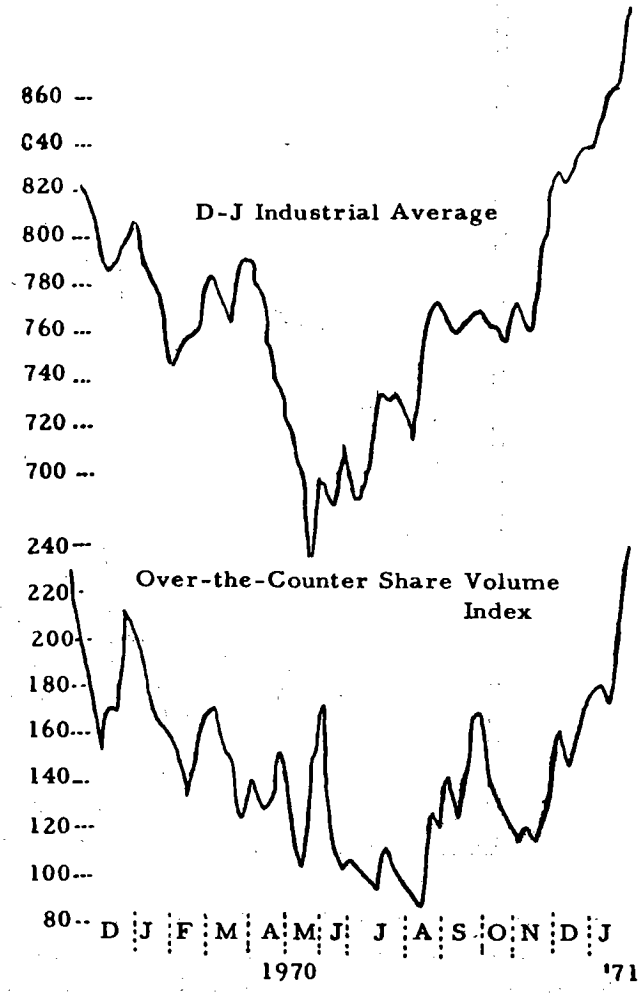
Now in the current situation, I don't think either of those elements are present. The people are not being told the truth, and they know it. Second, the truth about the economy, in my opinion, is unfavorable. In other words, the American people are being told a pack of half-truths and nonsense about a situation which, at best, is not too good. How Mr. Burns or the Administration expects this situation to lead to confidence is beyond me.

For instance, the latest super-puzzler is that the Administration is readying construction industry curbs or an actual industry wage-price freeze. Now aside from the fact that President Nixon has said that he is against wage-price freezes, aside from the fact that the Administration has stated that inflation is now easing, one wonders how in the world they are going to institute a wage-price freeze in a single, huge industry. To me it is like a mother taking her 300-pound son to the doctor, and the doctor saying, "Well, what really shows are his obese little arms, so what we're going to do is to try and spot-reduce his arms from the elbows down. That ought to do it." And if the Administration can spot-reduce the construction industry, I say, "Unbelievable, we haven't got politicians in Washington, we have magicians."

To turn to the market itself, it seems apparent to me that the funds are acting literally like the odd-lot public, plunging in and out and trading huge blocks of stocks as if they were tossing around 20-share bundles of odd-lots. In the week ending February 12 (see Barron's, page 24) there were no less than 251 "large block transactions" or trades of 20,000 shares or more, a record number. Like late-arrivals at a big-name concert, the funds are pouring in with what is left of their cash in a frantic attempt to be up-to-their-ears in stock while "the new bull market" is on. Still smarting from their dismal performances of the downside during 1969-70, the funds know that their single best advertisement is beating the Dow on the upside as long as the upmove is still in force.

And the fund thinking (if indeed, there is any deep thinking) is all based on distributing all these shares to the public "at the top". Yet many forget that approximately 75% of all outstanding shares are still held in private hands, not in the hands of institutions. And I find myself wondering who is feeding out all these hundreds of millions of shares to the funds, feeding them out so rapidly that it is taking (see later section) better than 10 million shares of volume to produce each 1 point of gain on the D-J Industrial Average.

Meanwhile, the statistics are getting a bit scary. For instance, last week the stock-bond ratio was back at 1.14, just a hair from its highest point in history (equal to the 1.14 of December, 1968 (see Letter 485). On the same week ending February 12, the over-the-counter volume index careened to 241.3, new high for the year, and higher than the 1969 peak of 235.1 which was recorded in November, 1969 (see accompanying chart).



As mentioned in the last Letter, the daily new high index topped at 231 on January 18, 1971, while the five-day average of daily new highs peaked at 208 on January 22, 1971. The best levels obtained since then was the 220 daily new highs of February 1 and the 185 for the five-day moving average recorded February 4. Thus with the Dow and the advance-decline ratio higher in February than in January, the market momentum, as measured by new highs, has been subsiding.

Odd-lot short sales are running extremely low, showing a disbelief on the part of the odd lotter regarding the possibility of a major decline. And although I do not have the new short interest figures (this will be covered in the next Letter), it is most probable that the recent record-breaking volume has taken the short interest ratio below the critical 1.0 figure, while the short interest in the 30 Dow Industrial stocks could be at a very low and bearish figure. In all, the technical picture is growing progressively more lopsided and bearish, and to say caution is necessary is like telling a race-car driver going 400 M.P.H. to be sure to fasten his safety belt.

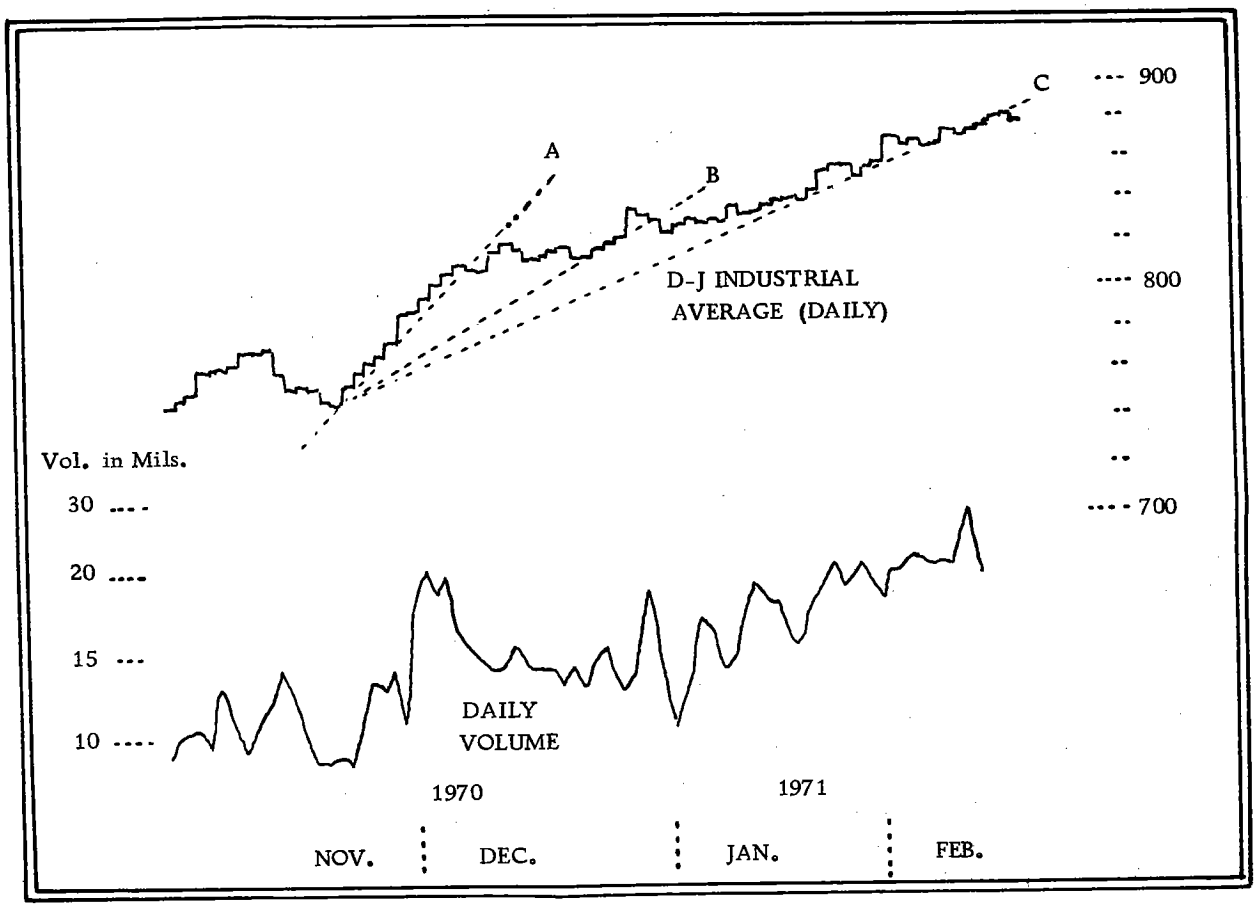
THE RALLY: Bear market rallies, as the great Dow Theorist, Robert Rhea, pointed out, usually come in the form of two major advances separated by a downward movement. More often than not, bear rallies terminate amid an explosion of volume, and anyone who has charts of the 1929-32 market action can easily verify this. For instance, the trememdous correction which ended in April, 1930 (following the 1929 crash) ended with more volume at its top than was seen at the bull market top in 1929.

As I see it, the upward correction which began in May, 1970 (Dow at 631.16) had, as its first upward phase, the move from the May, 1970, low of 631.16 to the September, 1970 peak of 773.14. From that point, although the Transportation Average entered into a steep decline, the Industrials moved sideways and formed what is known in Dow Theory as a "line". A line will often form in a particularly strong movement in lieu of a downward correction, and this seems to be the case following the September, 1970, peak.

The Industrial line continued to late-November, 1970, and on November 18 the Dow closed at a low of 754.24. The entire sideways or "line" movement can be studied on the page 1 chart. From the November low of 754.24, the Dow entered into its second upward corrective phase, and I have drawn this movement on the accompanying chart to semi-logarithmic scale (actually, this is merely a blow-up of the most recent section of the page 1 chart).

It was on the second phase of the rise that the real volume came in. In fact, volume, as seen on the chart, rose during late-December, January and February to record proportions. It is incredible when we remember that the worst day of the 1929 crash brough in "record" volume of 16 million shares, but during the last month we saw day after day of new record volume with the N.Y.S.E. producing totals of over 20 million shares.

Note on the page 4 chart that I have drawn three trendlines (marked A, B and C), each measuring a shallower rate of ascent than the previous one. The first trendline was broken by the Dow in early December, 1970, the second trendline was broken in late-December, and the third (the longest, shallowest and most important of the three) held until last week. Note that although trendline C traces out a mild upward slope, it required record volume for the Dow to hold to this trendline, and even with this unbelievable volume, the lifting power of the Dow was growing feebler as each successive trendline was established.



On Wednesday, February 17, the Dow broke below trendline C, even as news of fresh new prime rate cuts and expected discount rate cuts filled the air for the umtieth time this year. With the breaking of trendline C, it is quite probable that the first important test on the downside is building. With an area containing the greatest trading volume in stock market annals just behind it, the downside test as this bear market moves on, should be of more than passing interest.

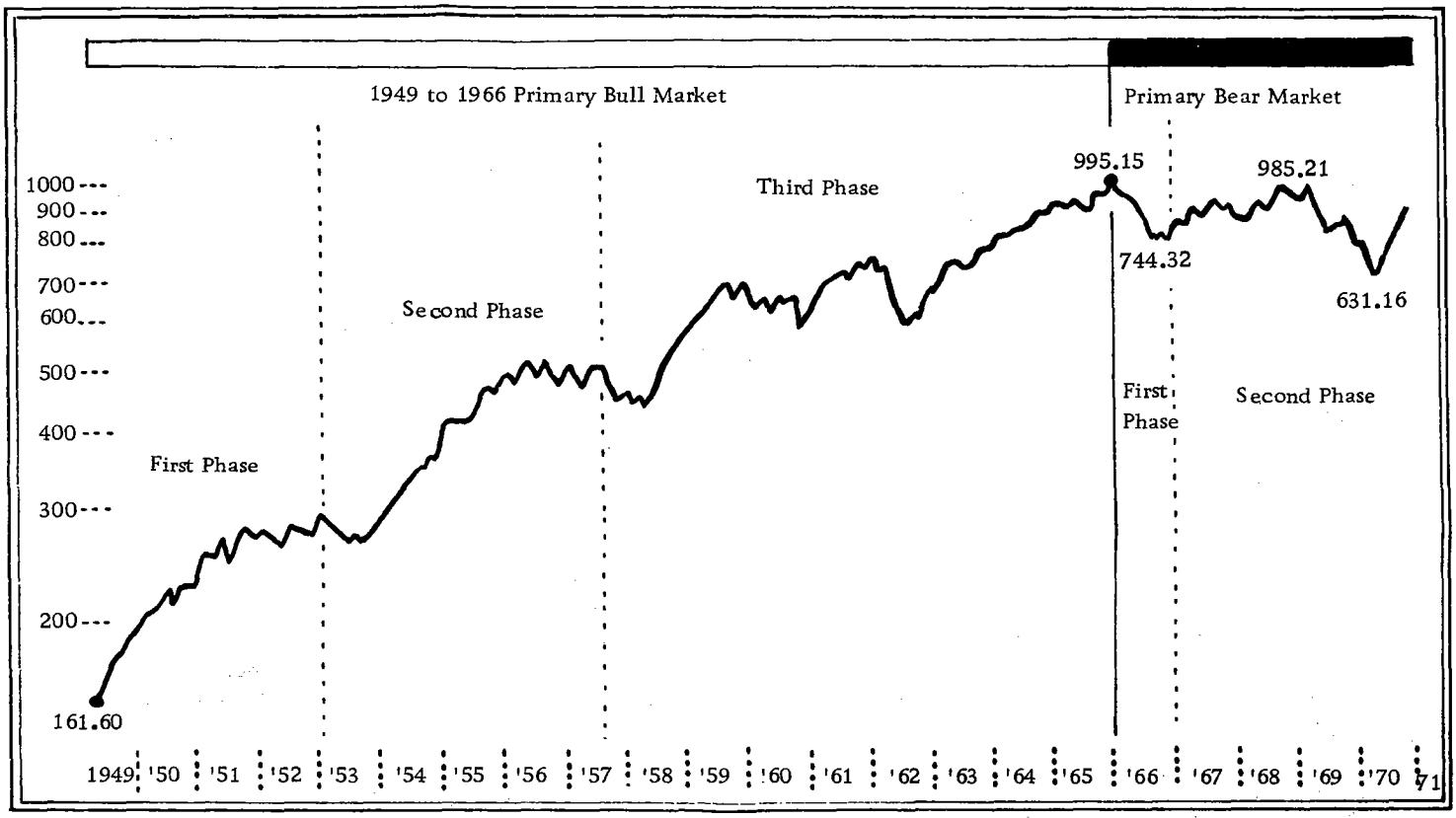
THE PRIMARY TREND: I have included a chart (see page 5) showing the path of the Dow Industrials from June, 1949, (when the great 1949-66 bull market began) to the present. What I want to illustrate and talk about here is the relentless force of the primary trend.

It is notable that all through the first two phases of the bull market, or from 1949 to 1957, the public was basically not in tune with the primary trend. The highest average daily volume on the upside during that whole period was 3-4 million shares at a few areas such as in late 1954 and again in early 1956. In other words, the public was singularly disinterested in the accumulation stages of the greatest bull market in history.

It was not until the late stages of the third or final phase of the bull market, during October-December, 1966, that the crowd piled into the market, and for the first time volume pushed out of the 5-6 billion share class into the 8-10 million share per day area. This final burst of bull market volume came approximately five months before the final bull market top in February, 1966.

It was here that the public became irresistably drawn to Wall Street. Speculation turned rampant. Even as the public roared in on record volume, the great bull market was breathing its last. Five months after the record volume began, the bull market topped out (February, 1966). The first leg of the bear market was immediately on its way.

The initial downward leg carried the Dow from its peak of 995.15, to an October, 1966, low of 744.32. Though steep and vicious, the early phase of the bear market was calm and quite orderly. And at no point could it be said that the market was in a state of panic. The public, to put it bluntly, was not easily moved on the bearish path. The first upward correction started in October, 1966, at 744.32. By early 1967 volume had climbed into the 10-million share class. By April, 1968, volume rose to the 12 to 18-million share area. The fact was that the public was showing far more enthusiasm during the first upward correction in the primary bear market than it did at any point during the preceding 17-year bull market!



The advance carried from the 1966 low of 744.32 to the 1968 peak of 985.21. In so doing it took the Dow within 10 points of its 1966 bull market high. From there, a crash-decline (the second downward leg of the bear market) carried the Dow to 631.16, in May, 1970. The violence and intensity of the decline surpassed anything seen since 1937, and a generation of Wall Street "gun-slingers", funds, traders and the public were dumbfounded.

The 631.16 point proved to be the Industrial low for 1970. Rebounding from the worst Dow collapse in 33 years and the worst breadth collapse (i.e., a smash in all stocks as gauged by the advance-decline ratio) in history, the Dow headed up again. The automatic rebound was given impetus by a massive barrage of Government propaganda, and a later incredible flip-flop by President Nixon, who suddenly announced that he had become a "Keynesian". In the face of a complete reversal to planned deficits by an Administration which had originally run on an anti-inflation program, volume rose to a frenzied level that surpassed even that of 1967-68.

On the week ending February 1, 1971, exchange volume passed the 100 million mark for the first time in stock market annals. The next week (week ending February 8) saw volume rocket to 105.7 million shares. Incredibly, the week ending February 12 saw another new record as volume soared to 110.6 million shares. Perhaps significantly, the Dow on those three weeks rose 7.19, 8.07 and 12.26 respectively, meaning that it required 11.6 million shares on average during those three weeks for each 1 point of rise in the Dow. Judged in the light of past market history, a fantastic amount of money was pouring into Wall Street to produce very little in the way of percentage gains.

So here we are, with the Dow and the market attempting to stage a repeat of 1967-68. Yet the bear market is much older here, and the underlying forces of the bear are considerably stronger. Compared to October, 1966, when the first major correction began, corporate liquidity is now much lower, the factory operating rate is lower, inventories-to-sales are higher, profits are in a worse squeeze, inflation is worse, deficits are higher, bankruptcies are much higher, productivity is lower, and it is taking far more volume (money) to move the market up against the trend here than it did during 1967 and 1968.

Shortly, I feel, the market is going to have discounted the best that can be seen ahead as the economy pushes upward against the primary bear tide. Yet as night follows day, I know that this primary bear market is ultimately going to

express itself. And my guess is that it is going to express itself with a savagery and intensity which will astound Wall Street and the nation.

The sad part of it all is that people can delude themselves into believing what they want to believe. Everybody wants to believe that the Government can hold off the forces of correction (i.e., the bear forces) forever. Politicians want to win elections, and they seem capable of doing anything and everything (including jettisoning their own beliefs) in the vain hope of "making everything all right" at least until election time.

But just as the bull market of 1949-66 would not be denied (it would not be denied through four economic recessions, Korea and Sputnik and Eisenhower's heart attack and the Suez crisis and what have you) so the bear market will not be denied. It will not be denied despite Government wishes, the inflation of the money supply, the bailing out of bankrupt corporations and a thousand other manipulations.

Over the past month we have seen that it takes the greatest concentration of volume in the history of the N.Y.S.E. to keep this bear market correction tilting upward. It has taken lowered money rates, discount cut after discount cut, massive Government spending and promises, and daily glowing forecasts from the highest levels in the land.

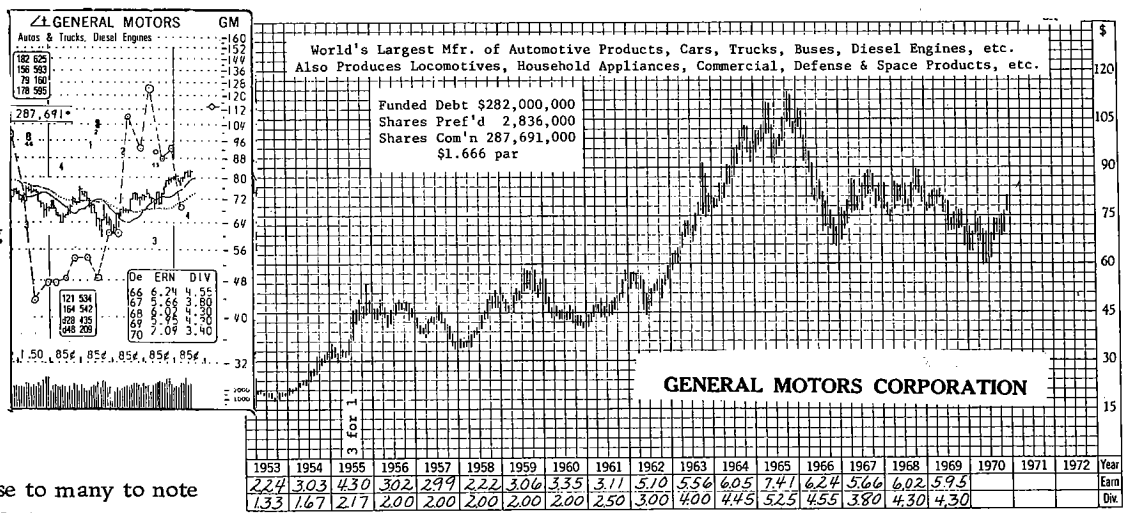
Yet despite all, the 995.15 bull market high of February, 1966, still stands. Each major thrust from a new bear market collapse-low requires more volume, money and propaganda to push the Averages higher. I view the current rise, not as a great area of accumulation and buying in a budding new bull market, but as a burning up of fuel as the "perpetual optimists" throw in all they have in a vain effort to rekindle the dead flames of the 1949-66 bull market.

To my mind, every dollar spent and every share traded on the upside during this advance means additional potential loss when the bear finally takes the market in its steely grip again. It is well to remember that the first two major downward legs of this bear market (i.e., 1966 and 1969-70) occurred on what Paul Dysart of Trendways calls "negative volume". This means that the great majority of the declines came with volume contracting on days when declines outnumbered advances. This negative volume phenomenon was the main reason why panic never appeared during 1966 or during 1969-70.

My own "feeling" is that the next major, downward leg of the bear market will occur on positive volume. This means that volume will tend to expand on days when declines outnumber advances. Positive volume declines in primary bear markets invariably produce a psychology of panic. That is what I see in store for Wall Street, once the current counter-primary forces have given way to complete exhaustion. It will not be a pretty sight, and I hope all my subscribers are in a position to watch the decline from the sidelines.

GENERAL MOTORS:

Periodically I like to review the action of GM, which may be considered the greatest consumer stock of them all. The accompanying chart (courtesy of Horsey, Salisbury, Md. 21801) shows the monthly range of GM from 1953 to the present.


GENERAL MOTORS GM
Autos & Trucks, Diesel Engines
World's Largest Mfr. of Automotive Products, Cars, Trucks, Buses, Diesel Engines, etc.
Also Produces Locomotives, Household Appliances, Commercial, Defense & Space Products, etc.
Funded Debt $282,000,000
Shares Pref'd 2,836,000
Shares Com'n 287,691,000
$1.666 par
GENERAL MOTORS CORPORATION
3 for 1
1953 1954 1955 1956 1957 1958 1959 1960 1961 1962 1963 1964 1965 1966 1967 1968 1969 1970 1971 1972 Year
2.24 3.03 4.30 3.02 2.99 2.22 3.06 3.35 3.11 5.10 5.56 6.05 7.41 6.24 5.66 6.02 5.95 Earn
1.33 1.67 2.17 2.00 2.00 2.00 2.00 2.00 2.50 3.00 4.00 4.45 5.25 4.55 3.80 4.30 4.30 Div.

It may come as a surprise to many to note that GM has, so far, failed to regain even half its bear market losses from the 1965 high of 113 3/4 to the 1970 low of 59 1/2. Currently, the rise in GM is tending to flatten out, as seen on the smaller weekly chart (courtesy of Quote Digest, 403 N.Main, Wichita, Kans.). Discounting the strike, earnings on GM have been in a downtrend since 1965, and I view the stock as having topped out for a long time to come.

Highest labor costs, vicious and increasing foreign competition, consumer discontent regarding quality, preference for smaller and less profitable cars, all these and other factors are working to confront GM with what may be its most difficult years since the 1930's. I would avoid the stock assiduously.